DISTURBANCES IN THE U.S. SECURITIES MARKET

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

RECENT DEVELOPMENTS IN THE U.S. GOVERNMENT SECURITIES MARKETS ARISING FROM DEFAULT BY DRYSDALE GOVERNMENT SECURITIES, INC.

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CONTENTS

TUESDAY, MAY 25, 1982

	Page
Opening statement of Senator D'Amato	1
Opening statement of Senator Brady	2

WITNESSES

Mark Stalnecker, Deputy Assistant Secretary for Federal Finance, Department of the Treasury	2
Marketable issues	3
Dealers' role in securities	4
Impact of default	5
Insufficient collateral	6
Market reaction	8
Informal surveillance	9
Additional regulations not required	11
Potential problem situations	11
Level of responsibility	13
Anthony Solomon, President, Federal Reserve Bank of New York	15
Market pressures	15
Blind brokering	16
Prepared statement	18
Introduction	18
Overview of the Government Securities Market	18
Drysdale Government Securities, Incorporated	20
Chronology of the Drysdale situation	24
Implications of Drysdale situation	28
Collateral to cover accrued interest	31
Types of financing transactions	34
Primary dealer reporting	38
Policy position of the Fed	40
Summary of meeting with officers of Drysdale	39
Donald Malawsky, Regional Administrator, New York Regional Office, Securities and Exchange Commission	42
Impact on broker-dealers	42
Market reaction	43
Registration with SEC	46

DISTURBANCES IN THE U.S. SECURITIES MARKET

TUESDAY, MAY 25, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:45 a.m., in room 5302, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Brady, Riegle, and Proxmire.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The subcommittee will come to order.

This hearing has been scheduled to inquire into the widely publicized controversy last week attending the inability of Drysdale Government Securities, the Government securities dealer, to meet substantial interest payments owed to institutions from which it had borrowed securities. These payments were first estimated to be approximately $160 million. Subsequent disclosures indicated they might go as high as $270 million.

These payment obligations apparently arose out of a large volume of transactions involving many financial dealings and rather complex relationships. It's been reported that if the Chase Manhattan Bank had not agreed to make these overdue payments, several major investment banking firms could have failed. The ripple effect of these dramatic developments can still be felt in the Government securities market, as well as in the corporate securities market.

Obviously, all of the relevant facts necessary to evaluate precisely what occurred, why it occurred, and what the long-term implications may be are not yet known. The purpose of this hearing is simply to learn those facts which are now known to the Federal agencies with responsibilities in this area. In particular, the subcommittee world like to know the steps they have taken to remedy problems which have been uncovered and to assure public confidence in the market.

Among the important questions which are being asked by both the public and professionals are the following:

Were the events of last week an isolated occurrence or could they be repeated?

Was the default a result of fraud, inadequacy of regulation, or some combination of both?

What are the implications of these events for the continued smooth operation of the Government securities market?

What are the implications, if any, for monetary policy and for the Treasury's ability to manage the public debt?

We will begin to explore the answers to such questions today. It is certainly possible that the agencies' findings may ultimately call for further study of the structural or regulatory environment of the Government securities market by the subcommittee. But such an inquiry would clearly be premature at this time.

We will hear this morning from Mark Stalnecker, Deputy Assistant Secretary of the Treasury for Federal Finance; Anthony Solomon, President of the Federal Reserve Bank of New York; and Donald Malawsky, Regional Administrator of the SEC's New York office.

I want to thank these distinguished witnesses for appearing before us today. I also thank Senator Brady for taking the time to be here today and providing us with the benefit of his expertise in this particular area.

As I noted before, the subcommittee appreciates that some of the facts may not be known at this time due to the short interval of time which has passed since the default. In addition, the subcommittee will be sensitive to the confidentiality of matters which may be the subject of possible enforcement actions. Notwithstanding these limitations, I am confident this hearing will help to illuminate the important issues which have arisen to provide the subcommittee with facts necessary to carry out its oversight responsibilities.

Senator Brady.

OPENING STATEMENT OF SENATOR BRADY

Senator BRADY. Thank you, Mr. Chairman.

I don't really have very much to add to your introductory statement. But I think it is a good idea that this hearing take place. The Drysdale Government securities matter is something that has caused a great deal of interest, not only in the press but here in Washington.

I am grateful this morning that the witnesses would take time from their busy schedules to help us try and understand this matter, which involves a large amount of money and some of the major financial institutions in the country.

Like the chairman, I realize that the facts can't all be known at this particular moment in time. But I think it is of importance that we make a start in trying to understand what happened.

Thank you very much.

Senator D'AMATO. Mr. Stalnecker.

STATEMENT OF MARK STALNECKER, DEPUTY ASSISTANT SECRETARY FOR FEDERAL FINANCE, DEPARTMENT OF THE TREASURY

Mr. STALNECKER. Thank you.

Mr. Chairman and Senator Brady, my remarks today will address the general conduct of business in the market for U.S. Treasury securities. I hope the subcommittee will find this information

useful in its inquiry into the market's problems last week, which apparently were caused by financial difficulties at one firm. Although the Treasury has been kept informed of developments during the past week, direct Government activity in this matter has been undertaken mostly by the Federal Reserve and SEC. Therefore, I will not have any specific comments on last week's market disturbance.

The U.S. Treasury market has grown dramatically in recent years. On April 30, total debt outstanding subject to limitation stood at $1,066.6 billion, compared to about $700 billion at the end of fiscal 1977. Of this amount $726.7 billion was held by the public, while Government accounts and the Federal Reserve System held almost $340 billion.

MARKETABLE ISSUES

The debt includes both marketable and nonmarketable securities issued by the Treasury. Marketable issues include:

First, Treasury bills, which are sold at a discount and have maturities of less than 1 year.

Second, Treasury notes, which have semiannual interest coupons and maturities from 2 to 10 years.

Third, Treasury bonds, which have semiannual coupons and maturities in excess of 10 years.

The Treasury currently sells all of its marketable bills and coupon securities in competitive auctions. Treasury announces its auctions publicly, making the amount and other terms of the sale available to the financial press and news wire services simultaneously, so that no news organization or market participant has the advantage of advance information.

Dealers and investors submit subscriptions to Treasury offerings directly to the Treasury or to Federal Reserve banks and branches which act as the Treasury's fiscal agency.

Dealers in U.S. Government securities often are awarded the major share of issues in competitive auctions, and these dealers subsequently distribute the securities to their customers.

Dealer profits or losses on the transactions are determined by the difference between the price the dealer pays to the Treasury and the price the dealer receives from the customer. The dealer's capital is at risk in each transaction since the dealership is trading for its own account.

A large number of institutions participate actively in this "new issue" market for Treasury securities. However, most of the trading activity occurs among the 36 so-called "primary reporting dealers," who are headquartered primarily in New York City.

The Federal Reserve System and Treasury Department exercise an informal surveillance role over these dealers' operations, with the primary dealers reporting daily their positions and volume of transactions to the Federal Reserve. They also submit data on their financial status every month.

The primary dealers are eligible to deal directly with the Federal Reserve Bank of New York. While other firms may have active trading operations, unless they meet the reporting and financial re-

quirements of the Federal Reserve, they are not considered primary dealers and may not transact business directly with the Fed.

In addition to these formal reports, the Federal Reserve and Treasury have regular informal communication with the market. Dealers meet daily with the Federal Reserve Bank of New York, and Treasury personnel maintains routine telephone contact with market participants to discuss current market developments and trends. All of these vehicles allow the Treasury to stay in touch with current market activity.

DEALERS' ROLE

I would like now to comment on the dealers' role in maintaining a liquid, efficient secondary market in Treasury securities. Both bank and nonbank dealers act as market makers for Treasury obligations. Because they deal for their own accounts, dealers inevitably hold "risk positions" which subject their capital to the risk of market fluctuations. These positions are often a significant multiple of the dealer's capital base. Thus, the dealers must borrow to finance these holdings.

Dealers rely heavily on so-called "repurchase agreements"—RP's—to finance their holdings of securities. In an RP, the dealer agrees to sell a security and commits to repurchase the security on a specified date a few days or weeks hence. These agreements can be arranged directly between the lender and dealer—so-called principal transactions—or through brokers who match up dealers and investors as agent. The dealer pays the investor an agreed upon rate of interest on the "loan." Normally the investor obtains some margin of safety by lending the dealer an amount of funds that is somewhat less than the market value of the securities involved.

Dealers also arrange so-called reverse RP's; that is, they buy securities from another party who agrees to repurchase the securities at a later date. The dealer receives an agreed upon rate of interest on this loan. Dealers can then sell these securities short in hope of buying them back at a lower price, or the dealer can place the securities out on RP and try to pay less interest on the RP than that earned on the reverse RP. This operation is often called a "matched book" operation, because the dealer is not exposed to any interest rate risk, although there is a credit risk in the event that one party cannot perform its part of the bargain.

Institutions engaged in these financing operations are responsible for screening the credit quality of the parties with which they conduct business. As a result, most firms have an approved list of customers with whom its traders are allowed to deal. The financial condition of parties involved in dealings is thus monitored continuously by market participants.

Most trades in Treasury securities are cleared electronically through the Federal Reserve wire system, which allows dealers, through their bank clearing agents, to transfer securities and funds quickly among themselves, without actually handling physical documents. This improves the timely execution of transactions.

The major differentiating feature of U.S. Treasury securities is the complete absence of credit risk from the securities themselves. Unlike corporate and State and local government securities, there

is no risk of default on U.S. Government debt. This allows market participants to trade Treasury obligations as homogeneous, risk-free assets, without needing to undertake extensive evaluations of the financial health of the issuer. However, as I mentioned earlier, participants must still take due care to assure that those with whom they deal are financially sound and can meet the terms of transactions. The Treasury market is the most liquid and efficient in the world, as evidenced by the Treasury's ability to market large amounts of new debt over the past few years, and the ability of investors and traders to efficiently buy and sell outstanding Treasuries in the secondary market. The Treasury is confident that this market will continue to function efficiently in the years ahead.

Mr. Chairman, that concludes my prepared remarks on the Treasury market, and I will be happy to try to answer any questions at this time.

IMPACT OF DEFAULT

Senator D'AMATO. Thank you very much. Let me put to you a rather basic question: What would have happened if Chase and the other banks had not agreed to make good on Drysdale's obligations? How would that default by Drysdale have affected the liquidity and safety of the Government securities market, and would it have discouraged investment in Government securities?

Mr. STALNECKER. It's very difficult to answer that hypothetical question with complete confidence, but I would say that before it became known in the marketplace that Chase was going to make the interest payments, and there was some uncertainty for several hours last week as to whether or not the Chase bank would make good on the interest payments, the market continued to function, although there was some uncertainty among those dealers that had interest payments due them.

My own belief is that in the event that Chase hadn't agreed to make payments, the market would have continued to function. However, certain dealers that were rumored to have large amounts of interest due relative to their capital base, might have had more difficulty arranging financing than they otherwise would have. In some cases, if the amount of interest due was large enough relative to their capital base, they might have found the market completely closed to them.

The answer in summary is that it would have created more uncertainties in the marketplace, but I don't believe it would have caused a collapse in the marketplace by any means.

Senator D'AMATO. Would it have driven up costs substantially to the Government?

Mr. STALNECKER. I think to the extent we did have some auctions last week and additional uncertainty in the marketplace always results in lower prices for securities, it could have conceivably cost more money for us last week when we sold our 2-year notes on Wednesday.

Senator D'AMATO. How much would that be?

Mr. STALNECKER. I have no way of knowing.

Senator D'AMATO. Could you find out for us?

Mr. STALNECKER. I'll look into it.

[The following information was received:]

The market uncertainties surrounding resolution of the Drysdale problem do not appear to have had an adverse impact on the Treasury auction of 2-year notes. Treasury received $13.3 billion of bids and awarded $5.5 billion of notes to the public, a coverage ratio of $2.42 bid for each $1 awarded compared with $2.01 in the auction of 2-year notes in April.

TREASURY AUCTION OF 2-YEAR NOTES—AUCTION: MAY 19, 1982—SETTLEMENT: JUNE 1, 1982

[In percentage]

Date	Treasury 2-yr curve rate [1]	New 2-yr note
May 13	13.95	(2)
May 14	13.86	(2)
May 17	13.85	(2)
May 18	13.85	(2)
May 19	13.78	[3] 13.79
May 20	13.48	[4] 13.48

[1] Yield quotations, except for auction results, are as of 3:30 p.m. and do not reflect after-hours trading.
[2] Not available.
[3] Auction average.
[4] When issued trading.

Senator D'AMATO. What would have happened if Chase and the other banks had not agreed to make good on Drysdale's obligations, in your opinion?

Mr. STALNECKER. As I just mentioned, I think it would have created more uncertainty in the marketplace. Certain dealers that have been rumored to be exposed might have had trouble arranging financing and might have been unable to continue to deal in the marketplace.

Senator D'AMATO. Could you tell us exactly what took place to cause the default? I think the public is very interested in how did this come about.

INSUFFICIENT COLLATERAL

Mr. STALNECKER. Well, the Treasury, as I mentioned in my testimony, has been kept informed of the developments in this matter, although we have not been taking an aggressive role in terms of trying to ferret out all the facts. My understanding is that what happened here was that the Drysdale firm had borrowed many securities through the Chase and from other dealers, which they then shorted in the marketplace. As is usual business practice, collateral was given to the dealers that lent the securities, but the collateral did not cover the accrued interest on the securities. It merely met the market value of the principal amount, and last Monday happened to be a coupon payment day for many Treasury obligations outstanding.

If you are borrowing a security, you have to pay that interest back to the person lending the security to you. My understanding is that when the coupon payment date arose last Monday, Drysdale could not make the payment. When the securities firms lending the securities came to the Chase, whom they were dealing with, and asked for payment on the interest coupons, there was some question in the first stage as to whether or not Chase was going to make payment or whether they would claim that by acting as

agent, they had no liability and the dealers would have to look ultimately to Drysdale. So the major problem here was that the dealers receive the amount of money that was due them in the form of interest payments, although the rest of the loan was fully collateralized by other securities.

Senator D'AMATO. Would that be an indication that in fact there wasn't sufficient collateral there?

Mr. STALNECKER. In this particular case it appears there might not have been enough collateral. I would like to point out, however, that the firms were dealing with a rather large bank, which in their view limited their risk somewhat, and ultimately interest payments were made and the private sector was able to work out a solution to the problem, which I think does speak well for the system in terms of the ultimate resolution in this case.

Senator D'AMATO. But doesn't it indicate a shortcoming in the system that a rather small securities firm, with capital of less than $20 million, could potentially bring about a major disruption in the marketplace? Does it seem to you that some aspects of these transactions should be looked at more closely, let's say, for example, the collateral. How do you guarantee that sufficient collateral in these kinds of transactions will be posted? Isn't that a necessary step?

Mr. STALNECKER. It certainly is a necessary step. I believe many dealers are reevaluating their own internal procedures as a result of last week's problem.

I would take issue somewhat with the characterization of this particular incident as a major disruption to the marketplace. It certainly has received a lot of press attention and headlines, but even before the Chase and the other banks involved agreed to make interest payments on these securities, the market did not come to a halt. There certainly was a lot of uncertainty. Dealers were scrutinizing whom they were doing business with, but the market functioned surprisingly well. I say surprisingly, given the headlines that were appearing at the time, and I would not say this particular incident was nearly as disruptive to the marketplace as some of the press accounts would lead you to believe.

Senator D'AMATO. If the banks were required to conduct all their securities dealings in a separate holding company affiliate, as the Treasury has proposed in its bank holding company deregulation bill, would the outcome or implication of these events have been altered?

Mr. STALNECKER. Again, it's difficult to know, a priori, but I would say that if there were a separate securities affiliate that was not backed by the full capital of the bank and the bank holding company, then the dealers who dealt and the financial institutions who dealt with such an affiliate would scrutinize their transactions accordingly and take into account that the full capital base of the bank was not backing it up. It might be in the event of a securities affiliate dealing in the marketplace that this volume of transactions wouldn't have gone through any one institution, because the capital base would have been smaller. But it definitely would increase the scrutiny with which dealers would address their dealings with bank holding companies.

Senator D'AMATO. Senator Brady.

Senator BRADY. You mentioned the placing of collateral. Was the placing of collateral insufficient to cover the amounts of interest? Was that collateral placed with the Chase or with the investment firms who were clearing through the Chase? How does that work?

Mr. STALNECKER. I'm not aware of the specifics of this situation. Normally, the dealers would have collateral placed in their custody account at a bank. I would defer to the Fed and SEC witnesses on the specifics of this transaction, but it wouldn't surprise me if in normal practice the dealers, after they deliver the securities that they're lending to the Chase, the Chase would then credit their custody account with the securities that were put up as collateral.

Senator BRADY. Do you have any recollection as to what the market action was during these 4 or 5 days? Was there a noticeable disruption in the market for Government securities, or was that market fairly level during that period of time?

MARKET REACTION

Mr. STALNECKER. On Monday—there were some late afternoon rumors—the market was under some selling pressure, specifically in the coupon area. Rates rose by about 10 basis points in late trading on most coupon securities. Tuesday morning, when more information about the situation was available, the initial market reaction was a decline in prices. Long bond prices, if I recollect correctly, fell by about a half or three-quarters of a point.

However, very quickly after the market's opening, the market stabilized, and in the absence of any kind of Federal Government intervention or comments to the public, the market began to recover most of its losses. Again, this was before the Chase and the other banks involved agreed to make interest payments and while there was still a lot of uncertainty surrounding the events of the day. So I would say there was some disruption when the initial rumor hit, but the market basically continued to function. After the initial selloff Tuesday morning, it recovered.

Senator BRADY. In your opinion, is this an abnormal amount—it doesn't seem to me in the Government market that that's a very large swing. I'm just wondering whether your feeling might be as to whether a half point selloff is normal or abnormal?

Mr. STALNECKER. I don't believe the selloff on Tuesday morning was abnormal, except if you combine the weakness that occurred Monday with the weakness that occurred Tuesday morning, and in the absence of any other news to explain it, it could be considered somewhat unusual. But I would agree with you, given the volatility that we've seen in security prices over the past couple of years, the market volatility was not out of the ordinary at all. In our view, the market continued to function efficiently and without an extra amount of turmoil.

I would also like to point out that Wednesday the Treasury sold a record amount of 2-year notes in the marketplace, $5.5 billion, and although by that time there had been statements from the banks accepting that they would pay the interest due, the market bid very aggressively for the 2-year notes. The so-called tail between the average price paid and the lowest price paid was extremely small and we received over $13 billion in tenders for the

offer, so we sold our 2-year note at a very attractive rate relative to the market at the time. We did not notice any disruption later in the week.

Senator BRADY. Do you have any information as to the amounts of interest that wasn't being paid to the various investment firms, as to whether those amounts—obviously they were disturbing because they were in the millions of dollars, but with regard to their whole capital, I'm wondering whether you made any study as to whether this is something that might cause those firms to go out of business or whether this would be losses that would be easily sustainable.

Mr. STALNECKER. I do not have a breakdown as to the specific exposure of different firms relative to the capital base. I don't know if any of the other agencies that are investigating do, but I suspect that they have looked into that.

Senator BRADY. Thank you.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Mr. Stalnecker, you represent the Treasury Department, I take it; is that correct?

Mr. STALNECKER. Yes, Senator.

INFORMAL SURVEILLANCE

Senator PROXMIRE. In your statement you say the Federal Reserve System and Treasury Department exercise informal surveillance over these dealers' operations, with the primary dealers reporting daily their positions and volume of transaction to the Federal Reserve, and so forth. The primary dealer in this case was Chase; is that right?

Mr. STALNECKER. The dealer, that is the reporting dealer involved in this, has been the Chase, that's correct.

Senator PROXMIRE. Now, you rely, then, on Chase's capacity to stay on top of this and to know what's going on. You didn't have any contact with Drysdale; is that right?

Mr. STALNECKER. I did not personally have any contact. The Treasury did not.

Senator PROXMIRE. Nor did the Treasury Department?

Mr. STALNECKER. No.

Senator PROXMIRE. The Federal Reserve?

Mr. STALNECKER. I can't answer for the Federal Reserve.

Senator PROXMIRE. So what you have to do is really rely on a private institution to handle a situation like the Drysdale situation, and if they don't, then there's no protection for the investor or for the Government; is that right?

Mr. STALNECKER. Yes. I would say that the private firms are responsible for doing the necessary credit analyses on their customers so they don't put their firms' capital at risk. Ultimately, of course, the dealers who are doing business with these other firms that are not reporting, the so-called reporting primary dealers, must bear the risk of any losses that are sustained, so they normally exercise extreme prudence in analyzing the credit worthiness of the people they do business with.

Senator PROXMIRE. I'm sure they do, because the amounts involved are enormous, are they not?

Mr. STALNECKER. Yes.

Senator PROXMIRE. They could be losses of hundreds of millions of dollars.

Mr. STALNECKER. In aggregate, that appears to be the case, yes.

Senator PROXMIRE. Obviously something went wrong in this particular case. Is this a once in a thousand or once in a million kind of an instance? Is that very unlikely to occur again, or do you think it represents a fundamental problem that we have to address and correct, make sure that in the future our regulation is more comprehensive and more effective?

Mr. STALNECKER. I don't believe that based on the evidence available now—again, I would like to stress all the facts are not out yet—but based on the evidence we have now, it does not appear that there is a need for additional regulation of the market. The Treasury market, despite the massive quantities of securities outstanding and the large volume of trading that occurs every day, has worked efficiently for years, and this is a very isolated instance. I would also like to stress again that in this particular situation, the private sector was able to work out a solution in very short order with a minimum amount of disruption.

Now, it could be that Chase stockholders end up footing the bill, or depending on the ultimate outcome, other dealers might end up having their capital reduced by the amount of their exposure. But these are business risks and it's not the Federal Government's job to protect the stockholders and partners of different securities firms from mismanagement and poor judgments in their dealings with other investment groups.

Senator PROXMIRE. When Chase moved in, as I understand it, they moved in on the basis of their own discretion. If they wished to do so, they could have just walked away from this; is that right or not?

Mr. STALNECKER. Again, I'm not sure that this has totally been decided. It might end up being decided legally. My understanding is that Chase did reach its decision to make good on the interest based on its own internal management decisions. I think ultimately whether they had to do that or whether something else could have been done will have to be decided based on the facts as they unfold.

Senator PROXMIRE. One other question. When we established the Securities and Exchange Commission there was a lot of feeling on the part of many people, or even for that matter the Federal Deposit Insurance Corporation, that this was an interference with the free market; we shouldn't get involved in that. After all, there are normal business risks involved. Anybody who puts their money at risk has to expect that, and so forth.

What we find, I think almost everybody agrees, the Federal Deposit Insurance Corporation and the SEC have been excellent institutions. The regulations were provided to protect the investors wisely and prudently and permitted the free market to work better, not worse.

In this case, do you feel maybe we should reexamine this pretty thoughtfully and carefully and decide whether or not perhaps additional regulations might provide protections in the future that would enable the free market to operate better, even though we

would have to have somewhat more regulation on the part of the Treasury or the Federal Reserve?

ADDITIONAL REGULATIONS NOT REQUIRED

Mr. STALNECKER. No, I don't think that's required and I'd like to explain why. In the case of the SEC regulation of other securities, the major differentiating factor is that there is credit risk on the part of the issuer of the securities, whether it be the common stock or a bond of a corporation, and it is required for full disclosure to the buyer, that the issuer disclose fully its financial statements, and any of its current operating details that are of interest. In the case of U.S. Treasury securities, there is no default risk, which means the disclosure that would be required is minimal. And in my view, given that most of the trading that occurs is between institutions, there is also no small investor or the public that must be protected here. So I don't believe in this particular case it indicates any need for additional regulation of the Government securities market.

Senator PROXMIRE. Thank you.

Senator D'AMATO. Senator Riegle.

POTENTIAL PROBLEM SITUATIONS

Senator RIEGLE. Let me ask you, what steps has the Department taken since this happened to find out if there are other situations like this one out there that perhaps have not yet been discovered, that have not gotten into this degree of difficulty that we have seen in the case of Drysdale.

Mr. STALNECKER. We have been in constant contact throughout this incident with our fiscal agent, the New York Fed, which monitors market developments and, of course, receives daily reports for us.

Senator RIEGLE. What have you found?

Mr. STALNECKER. We don't believe at this point there is anything to suggest that this is other than an isolated incident involving this specific firm.

Senator RIEGLE. You don't know of a single other situation that is a problem situation or you have any concern about?

Mr. STALNECKER. I don't know of any at this time, no.

Senator RIEGLE. Might there be knowledge of a problem in the Treasury Department that you wouldn't have?

Mr. STALNECKER. No, if there were anybody in Treasury who knew of a potential situation, I would know about it.

Senator RIEGLE. How was it that there was no awareness of this problem?

Mr. STALNECKER. As in most of these dealings, there are certain trigger points at which events occur. There really is no way of knowing ahead of time whether the parties to a contract are going to be able to perform. In this particular instance there was no evidence of any problem because the securities were well-collateralized in terms of their principal amount. The thing that set off this particular problem was the coupon payment that was due last Monday.

Senator RIEGLE. But my question is this: This is not a small problem; it is a very big problem. As I understand it what you are saying to me is that you don't presently have a way of knowing when a firm is getting into this kind of trouble.

Don't you need some other way to measure performance along the way so that you discover problems like this before they grow to this size?

Mr. STALNECKER. Again, it is not the U.S. Treasury. The Treasury deals with the marketplace through its auctions. We do have what we feel are adequate safeguards to make sure that the people who bid in auctions will be able to take delivery. Once the market, the secondary market, trades the securities, aside from those dealers who actively make markets, the so-called reporting primary dealers who do report to the Federal Reserve System, we believe that the marketplace is the best disciplining mechanism to make sure that the others who trade actively in the market have adequate financial resources to meet their needs.

Now, the dealers, the primary dealers, who deal with these trading firms in the marketplace do extensive credit analysis, and it is up to their management to make sure——

Senator RIEGLE. Obviously, that didn't happen here.

Mr. STALNECKER. Again, there is nothing that can protect anyone who does business in the world from having a customer who defaults on his obligation, whether it is a manufacturing firm that extends trade credit to its customers or a dealer firm.

Senator RIEGLE. Maybe I am not making my question clear. That is, it seems to me that at some point, if the scale of the problem has grown to this size, there ought to be some mechanism, for seeing that it is developing so that it doesn't just happen as a surprise.

Well, you obviously didn't see it coming. Chase presumably didn't see it coming. Nobody saw it coming. I am just raising the question: is that an adequate—now that this is hindsight and we are looking back, is that an adequate situation, or do we need some way of trying to identify developing problems?

Mr. STALNECKER. I agree that it is incumbent upon the dealers who deal with lesser known or smaller firms to protect their own capital base and their own stockholders if they are publicly owned, but I don't think it is the Federal Government's role to prescribe capital ratios or prescribe limits on dealings with firms when it is not the Federal Government's capital that is at risk.

In this particular instance I would like to stress that a private market solution was found to the problems. Given the information that we saw throughout the week, the market repercussions, although there was some uncertainty early on, were minimal.

So, I guess to answer your question, I don't believe that there is a need for additional reporting or additional monitoring of the system given the system's performance to date. I grant you there will be isolated incidents from time to time which presumably will cause even greater scrutiny on the part of the dealer community with whom they do business.

LEVEL OF RESPONSIBILITY

Senator RIEGLE. Would you say then that this would essentially appear to be the responsibility of Chase in this case, to be keeping track of Drysdale more carefully and finding a way to measure whether or not they were able to meet their obligations? Would it be essentially their task? Obviously, Drysdale wasn't able to do it for themselves. So the question is: Who has the next level of responsibility to see that adequate protections are there and that people's money isn't put unduly at risk? Would that be Chase's responsibility?

Mr. STALNECKER. I wouldn't want to put all the burden of responsibility on Chase. Chase was not the only institution involved here, but it is the responsibility of the institution dealing with any brokerage firm or dealer operation to be comfortable that that firm will be able to meet its obligations. In this particular instance it appears that the Chase was the single largest entity involved in dealing with Drysdale, so presumably the Chase should have been carrying out these credit analyses.

Senator RIEGLE. From the stories that have been written, and it is an effort now to try to reconstruct them—as you yourself say, not all the facts are yet known to you or the Treasury Department so they are not known to us either—but it appears that when this first came to light Chase attempted to convince others to share in this liability, sort of pass it around, they would take a part and others take a part, and so forth. From the accounts that have been written, that was turned down.

There was a very short timeframe here and great nervousness as to what might happen, either with down-the-line collapses by others—at least this has been asserted by many—or just shaken confidence in the market; that they decided to step up their efforts and guarantee the entire loss, as I understand it.

I am concerned that although in this particular instance they were both able to do that apparently and willing to do that, had they not been so inclined, where would we have found ourselves?

Mr. STALNECKER. Then presumably some dealers would have suffered capital losses. I don't think it is a coincidence that these transactions were done through a well-capitalized institution. It is likely that many of the dealers, had there been only a smaller institution available to do these transactions, would have limited their risk accordingly, based on the capital position of whom they were dealing with.

Again, the facts aren't totally out in this matter, so I would hate to try to characterize what Chase did as the right thing or the wrong thing. But I would stress that the capital position of the institution was able to sustain this loss. I don't know what would have happened if it hadn't been the Chase; had it been some other, smaller firm. Perhaps the volume of activity wouldn't have occurred.

Senator RIEGLE. I guess the question we really need to answer, and we haven't answered yet, is: Are there other situations like Drysdale waiting to happen that we don't presently know about? You are saying you hope not or you don't think so or this is sort of a long-odds proposition? I would have gathered that maybe as re-

cently as 2 weeks ago, if someone had said hypothetically could this happen, could you have a Drysdale situation, the general supposition would have been no, that is not plausible, that is not likely to happen, and it is science fiction.

But now it has happened, and I am just wondering how do we assure ourselves that there aren't others like this waiting out there that may come as surprises tomorrow, next week, 2 weeks from now. How do we nail that down so we have some assurance that we don't have that kind of problem developing?

Mr. STALNECKER. My view that there aren't a lot of these disturbances hanging over the market is not based totally on hope or some blind faith in the market. It is based on an observation of troubles in the marketplace over decades, and the fact that these disturbances do occur from time to time I believe is just an indication that there is nothing that is riskless in the world of business.

But I think as the events of this particular situation unfold and as the facts are uncovered, both the private sector and the governmental agencies that are involved will have a chance to examine in detail all the transactions, and it is possible that procedures within the dealer community will change as they find out where some of the flaws are and what the weaknesses of the current structure are.

It could be, when all the facts are out, we will see that there are some changes that need to be made, but at this point, and based on the information that we have, I don't believe that there is any need for any kind of extensive reevaluation of regulation in the Government securities market.

Senator RIEGLE. That really isn't my question. My question is: Does a possibility exist that another Drysdale could happen next week, 2 weeks from now? What I take your answer to mean in terms of everything I have heard you say is that we don't know one way or the other.

Mr. STALNECKER. I cannot tell you, Senator Riegle, with 100-percent certainty that there won't be another situation arising, because you can't guarantee anything. But I would say that, based on history and based on the fact that this recent occurrence did arise and right now dealers are reevaluating their own exposure in other instances and other transactions and there is a heightened awareness right now on the part of the whole investment community of their own dealings, that right now the chances are probably lower of another event arising than they would have been, but I can't guarantee that.

Senator RIEGLE. There is tremendous stress all through the financial system. Everyone is feeling it. So the likelihood of more problem situations developing is real. You see it in every other part of the economy, and there is every reason to think that it exists within the financial community as well.

What I am wondering is: If it is not then sound policy for the Treasury Department to take it upon itself to try to figure out whether there are any other problem situations out there of any particular size?

I believe situations like this deal a real blow to public confidence, and the reason that this has received so much attention is it was unanticipated, it is a large item, and it is worrisome.

If there are others like this coming down the track, or even the potential exists, I think that is a very key public issue for you to deal with, for the Fed to deal with, and for the Congress as well to try to deal with.

So, my thought would be that you ought to take a very close look at this situation and try to determine whether there may be other situations like this building up; and, if so, see what might be done to try to stabilize the situation. I would hope we could find more surprises like this. I think it would be very hurtful if others were to occur any time soon.

Senator D'AMATO. If the Senator would yield, I would ask that Mr. Anthony Solomon, the president of the Federal Reserve Bank of New York, come up and join the witness, as well as Mr. Donald Malawsky, the regional administrator for the SEC's New York regional office.

Mr. Stalnecker, if you would stay in the hot seat for a while.

STATEMENT OF ANTHONY SOLOMON, PRESIDENT, ACCOMPANIED BY IRWIN SANDBERG, VICE PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. SOLOMON. With your permission, Mr. Chairman, I would like Mr. Sandberg to accompany me.

Senator D'AMATO. Certainly.

Senator Proxmire has to go to the floor, but he has a question he would like to put to Mr. Solomon and Mr. Malawsky personally.

So, for the purposes of that question, Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman. I very much appreciate that.

Mr. Solomon, Mr. Stalnecker stated a private sector solution was arrived at, meaning that Chase agreed to pick up Drysdale obligations. Was it always clear that Chase would pick up the obligation?

Apparently, there was a period when that was in doubt. I wonder if you could give us any insight into why Chase appeared reluctant to accept Drysdale obligations, but then changed its mind.

Also, apparently another bank from the outset decided to pick up its obligation from Drysdale.

Mr. SOLOMON. Yes, Senator, I can give you a picture of that.

Senator D'AMATO. Mr. Solomon, would you talk right into the microphone please?

Mr. SOLOMON. The initial reaction of Chase was that they were acting as agents and did not have the responsibility as principals. There were a series of meetings with the other key dealer firms that were involved.

Chase in this case was not acting really as the primary reporting dealer, although it happens to be one. It was acting as a clearer, and it met with those firms at the Federal Reserve Bank in New York. There were meetings Monday night, and then they had meetings on their own Tuesday morning. There was a meeting with the New York clearing house banks on Tuesday, I think around noon.

MARKET PRESSURES

Market pressures were building up on Chase. Chase itself was beginning to examine internally its position, and, even though it has

not given up its legal point and position and there clearly is a possibility of litigation, Chase came to the conclusion that a solution had to be found; that the needs of the market required them to step in and accept this responsibility, although at the time they made it very clear that they still reserved the right to maintain that they were agents.

As we say, that matter can only be settled definitively in courts.

Senator PROXMIRE. Let me interrupt and say, it seems to me that that suggests that we might consider the possibility of helping the courts along in the future by providing legislation. If an institution like Chase, under these circumstances, views its position as an agent and feels that the law would protect them, I take it they would do that because they want to act legally they actively believe it, doesn't that suggest then that in view of the fact that Chase and the other so-called agents would be regulated, but the principal, Drysdale, these other operations, are not, suggest that we should take another look at the responsibility of institutions like Chase in circumstances like this?

BLIND BROKERING

Mr. SOLOMON. I think we have to work through the ramifications of what is called blind brokering.

Senator PROXMIRE. Blind brokering?

Mr. SOLOMON. In my view, although I'm not a lawyer, the reason why there is a gray area, possibly—although the courts will settle that—is because of the practice of blind brokering. It confuses the question, possibly, of the agent's versus the principal's responsibility.

I feel that there will be an analysis, both in the government securities dealers and the association of government dealers, of this question of blind brokering, and whether there are ways of strengthening the procedures and clarifying that situation. We are participating. We at the New York Fed have volunteered to participate, and they welcomed our participation in these discussions that are going on now.

There were two basic problems that caused the Drysdale situation, Senator. One was this blind brokering practice that has grown up in the market, and the other was the point that Mr. Stalnecker referred to, that the collateral does not include the accrued interest on the coupons.

Senator PROXMIRE. Mr. Solomon, I hesitate—and I apologize. This is very rude. I simply have to go to the floor, but I'm sure that the other members of the Committee will carry on.

Mr. SOLOMON. Good to see you again, Senator Proxmire.

Senator PROXMIRE. Good to see you.

Senator RIEGLE. I would like to have you finish your response, if you would.

Mr. SOLOMON. It was a peculiar combination of these two factors that caused the Drysdale situation.

Now, those are going to be, I think, intensively studied, not only by the dealers' community, but we are going to participate in that. I think we have to see the outcome of that and arrive at our own

conclusions, and then we would discuss those with the Treasury, as well.

I think it would be premature, at this point, to talk in terms of rulemaking.

Senator D'AMATO. Mr. Solomon, let me ask you if you wouldn't summarize your testimony for us, so that we can then open the matter up to some further questions from the panel.

Mr. SOLOMON. Well——

Senator D'AMATO. Let me indicate that if there is no objection, that your written statement will be printed in its entirety in the hearing record.

[The complete statement follows.]

Statement by

Anthony M. Solomon

President, Federal Reserve Bank of New York

Introduction

Good morning. I am Anthony Solomon, President of the Federal Reserve Bank of New York, and I am here this morning to discuss the events of last week, centering on Drysdale Government Securities, Inc. and its activities in the Government securities market.

The Federal Reserve Bank of New York, acting on behalf of the Federal Open Market Committee, conducts the Federal Reserve's open market operations to implement monetary policy through purchases and sales of U.S. Government securities. Most dealers in Government securities are located in New York City, and many of the nation's largest banks are headquartered there. More than half of the Treasury's securities are sold through New York financial institutions.

Overview of the Government Securities Market

Before commenting on the events of last week I would like to present a brief overview of the Government securities market. The market for United States Treasury securities is the most active capital market in the world. It includes trading in Treasury bills, notes, and bonds. It is an over-the-counter market centered on 36 reporting primary Government securities dealers. Most of these dealers are located in New York City with

others in Chicago, Los Angeles, and San Francisco. The primary dealers include 24 nonbank firms and 12 bank dealers. The bank dealers are among the nation's largest banks. The nonbank group is heterogeneous, including some of the largest investment banking firms but also several firms, small and large, which confine their activity to Government securities and high grade money market instruments such as certificates of deposit and bankers' acceptances.

While there is no formal regulation of the market, the Federal Reserve exercises informal surveillance through its monitoring of reports of primary dealers. To qualify as a primary dealer, the Federal Reserve Bank of New York requires that a firm be actively engaged in the distribution of Treasury securities among investors, have adequate capital and capable management, make markets, and have a long-term commitment to the underwriting and distribution of Treasury securities. Drysdale Government Securities, while an active trader, was not among this primary dealer group.

Every business day, the 36 bank and nonbank primary dealers voluntarily report to the Federal Reserve Bank of New York their positions -- that is, inventories of securities -- and their trading activity. They also report on their profitability, and they submit financial statements. During the first quarter of 1982, daily trading activity in United States Treasury securities reported by these dealers averaged $28 billion. Activity has grown steadily over recent years as has the volume of marketable Treasury securities which now totals about $685 billion.

The cash needs of the Federal Government are met through the frequent sale of Treasury securities and many of these securities are bought directly by the primary dealers, who place bids in competitive auctions. The amounts vary, but these dealers usually purchase 35 to 75 per cent of the amount sold by the Treasury. In addition, they make markets -- that is, they stand ready to bid or offer Treasury issues to customers and to each other. It is this market and its efficient functioning that has given extraordinary liquidity to Treasury securities and enabled the Treasury to meet its huge financing requirements efficiently.

Drysdale Government Securities, Incorporated

Before discussing the details of the Drysdale situation, let me make a few general observations. First, during the course of the three days when the Drysdale situation came to light and was dealt with, I was home ill and in touch with the situation by telephone. Therefore, much of my testimony is based on reports from various colleagues at the Federal Reserve Bank of New York and the Federal Reserve Board in Washington. Second, because the events being discussed at this hearing occurred so recently, not all the facts are known as yet, and the time to prepare for this hearing has not permitted my testimony to be exhaustive. Third, it is likely that some of the issues involved here will become the subject of lawsuits and that only the courts will be able to resolve them.

Drysdale Government Securities Incorporated was incorporated on January 29, 1982 with stated capital of about $20 million. We understand that the firm was set up for the purpose of

carrying on the Government securities trading activity previously conducted by Drysdale Securities, a much older firm that now trades mostly equities and municipal bonds. Drysdale Securities, the older firm, has stated that, except for some common ownership, the two companies are separate and independent. The head trader and strategist of Drysdale Government Securities had been employed at the older Drysdale company prior to the establishment of the new firm.

For the remainder of my statement when I mention Drysdale, I will be referring to Drysdale Government Securities Incorporated. Drysdale traded actively and maintained very large positions in Government securities. The firm aspired to develop from a trading operation to become a primary dealer in Government securities and was reportedly adding salespeople to its staff recently. We believe that few of its transactions were with retail customers. As I noted earlier, the firm is not a dealer reporting statistics to the Federal Reserve but representatives of the firm had approached the Federal Reserve Bank of New York to ask about becoming such a dealer.

Drysdale's stated capital at inception of about $20 million, while not large for this industry, was within the normal range. Its problems apparently arose because its activities were conducted on a scale out of all proportion to its capital. We had not had any reports from Drysdale about the scope of its activities. Comments received from others, and knowledge of its bids in the auctions we conduct for the Treasury, suggested nothing unusual about Drysdale's scale of operations. On the

morning of Tuesday, May 18, when Drysdale's financial difficulties became so widely known that it was impossible for it to continue trading activities, our best information is that it had a gross long position of about $2 1/2 billion and a gross short position of about $4 billion. There are now indications that earlier positions had been substantially larger.

In all debt markets, of course, there is a risk that changes in market interest rates will decrease or increase the market value of outstanding securities. For this reason, speculation in price movements of United States Government securities can be a high risk activity, even though there is no credit risk from the issuer of the securities. Because of the leveraging of positions, even a modest change in interest rates and securities prices can have a significant impact on a firm's capital. In the last two to three years, the primary dealers have given more attention to managing risk. Drysdale, apparently, failed to contain its risk and left itself exposed to moves in interest rates.

The two main factors that permitted Drysdale to escape the normal restraints of the market place and become so overextended were (1) a scheme that temporarily added to its working funds, and (2) the routine acceptance of practices whereby banks and securities firms were not sensitive to the magnitude of exposure. First, let me review the techniques used by Drysdale to add to its working funds. Normally, the size of a firm's capital position should act as a restraint on leveraging since the standard practice of lenders in these markets is to require margin -- that is, collateral in excess of the funds or securities lent. A

major way that Drysdale raised working funds was to borrow securities with high-rate coupons on which a large amount of interest had accrued. The market practice is to ignore the value of accrued interest in pricing transactions involving the borrowing of securities. Drysdale sold the securities for market value including the value of accrued interest. Through these so-called short sales, Drysdale generated enough cash to cover the margin required by the lender of the securities and had some left over for use temporarily as working funds. It is a common practice to borrow securities to cover deliveries on sales; this practice can contribute to the liquidity of the Government securities market. But it did give Drysdale the temporary use of large amounts of accrued interest prior to interest coupon dates when it had to forward the interest to the party from whom it borrowed the securities.

On Monday, May 17, a day when a number of issues had coupons due, Drysdale was unable to raise the funds to pay the coupon interest to the lenders.

By itself even this scheme, which when done in billions of dollars can generate very large amounts of working funds, would not have permitted Drysdale to become so overextended. Normally, other participants would limit the amount of loans transacted with any one firm, the amount depending on the firm's known capital as well as its reputation. Drysdale escaped this restraint by doing most of its transactions through brokers in what is known as "blind trading." It may have been that neither

Drysdale nor the counterparty to the trades was aware of the other's identity. Market practice did not require them to be aware of the identity of the other party. The trades were put through banks. In the disputes that developed, the dealers asserted that they had dealt with the banks as principals, and so the coupon payments due on May 17 should be paid by the banks whether or not Drysdale made payment. On the other hand, the banks took the position that they were agents and that the lenders of securities had to rely on Drysdale for payment. This was the heart of the dispute between the banks and the dealers. Without taking a position on a legal matter, which might be tested in the courts, it does seem that the banks could improve their control procedures.

Chronology of the Drysdale Situation

The Federal Reserve first became aware of a potentially serious problem in the government securities market when Willard Butcher, Chairman of The Chase Manhattan Bank, called me on Monday, May 17 and in my absence arranged a meeting with a few of my senior officers. At that meeting, at 2:30 on Monday afternoon, two senior Chase officials described the extent of the problem and identified Drysdale as its source. Chase suggested that the Federal Reserve call a meeting of major market participants who were owed interest payments by Drysdale, where Chase would propose joint action to resolve the problem. After discussion with high level Federal Reserve officials, the Federal Reserve Bank of New York agreed to a meeting on its premises, to

which Chase would invite officials of the firms that it identified as being significantly involved in this situation. The meeting was held at 6 p.m. Monday. An officer of the Fed said at the start of the meeting that the Federal Reserve had a concern with the potential market consequences of the problem, had agreed to the meeting in order to learn more about the situation, and was not taking any position on any proposal that Chase might advance. Chase invited the participants at the meeting to join with Chase in an arrangement for the orderly liquidation of positions held by Drysdale and to provide funds for interest payments. After giving the dealers the opportunity to consider its proposal overnight, Chase reconvened the group at 7 a.m. the following morning at its premises. No agreement was reached because of a difference over who should bear the immediate loss.

During the evening on Monday and early on Tuesday, meetings were held in Washington and New York among Federal Reserve officials to explore the potential problems for the Government securities market and actions which we might take to deal with any secondary repercussions. Market participants were concerned that a bankruptcy of Drysdale might tie up large amounts of securities. The Federal Reserve informed officials in the Treasury Department, the Securities and Exchange Commission, the Comptroller of the Currency, and other agencies about the problem and contacted market participants to learn more about the problem.

Rumors of the situation had spread on Monday afternoon, contributing to a substantial decline in Government securities

prices. The market opened on Tuesday in a rather apprehensive and uncertain mood. By mid-morning Tuesday, Chase had confirmed its involvement with Drysdale in a public announcement which referred to $160 million in interest payments due on securities borrowed by that firm which had not been made. As awareness of the problem became widespread, other market participants became unwilling to do business or settle transactions with Drysdale. We also became aware by midmorning that Manufacturers Hanover had not received nearly $30 million in interest payments due on securities borrowed by Drysdale.

Beginning Tuesday morning, we had people working with Drysdale's books and records, such as they were, trying to develop a picture of Drysdale's financial affairs. By mid-day Tuesday the market uncertainty about clearing and financing arrangements seemed to be building. There was concern that investors and traders would pull away from the markets because of uncertainty about the magnitude of the problem, and that major securities firms would be threatened with losses that could jeopardize their ability to function. It was decided to hold an afternoon meeting with the twelve New York Clearing House banks. We told the banks that we were watching the Drysdale situation closely and stated that our discount window stood ready to assist commercial banks in dealing with unusual liquidity problems arising from the situation. Since there was some concern that the Drysdale matter might impede the flow of securities and related payments through the market we said that we would extend

the day's deadlines for our securities and funds transfer systems to allow time for the smooth completion of the day's work. After the meeting with the banks, we conveyed the same message by telephone to the 36 primary dealers. During that call, each dealer was asked to keep us informed about its exposure in the Drysdale situation.

During the rest of the day, Federal Reserve officials had discussions with senior officials of Chase and Manufacturers Hanover reviewing the options for a resolution of the situation, to reduce or eliminate the uncertainty, and restore more normal conditions in the Government securities market. At the same time, market pressures were building for Chase and Manufacturers to take action to deal with the problem. While the decision could only be made by the banks involved, after considering legal and business factors, it seemed likely that a decision to pay interest would have a calming effect. In the event the market performed fairly well on Tuesday with little net price change on the day though the background mood remained tense and apprehensive.

At 8:45 a.m. on Wednesday, Manufacturers Hanover announced that it would pay $29.3 million interest due its customers on account of securities borrowed by Drysdale and would complete the securities transactions it had executed for Drysdale.

In response to press inquiries regarding the announcement by Manufacturers Hanover, we said that we regarded it as an encouraging and constructive development that should help to reassure the markets.

At 10:15 a.m., United States Trust Company announced it was making interest payments involved in the Drysdale situation to its customers and that this action would not have a material effect on its financial condition.

Chase also announced, at 11:45 a.m., that it would pay interest due on securities involved in the Drysdale situation. It also announced an agreement with Drysdale to liquidate securities positions held by Drysdale which had been processed by Chase.

Market apprehensions had greatly diminished by mid-day Wednesday, following the announcements by the banks. Prices recovered that afternoon -- although a number of questions still remained as to how the unwinding process would be carried out. To assist that process, we told the primary dealers early on Thursday that we were prepared to make more flexible the terms of short-term loans of Government securities from the Federal Reserve portfolio.

Implications of Drysdale Situation

It would be premature to offer firm conclusions or recommendations based on our experience with the Drysdale situation. In part, any such conclusions or recommendations will have to depend on the sorting out and unwinding of the Drysdale transactions that is still going on. Quite likely there will be some complex disputes to be settled among the parties concerned, and their resolution could also have a bearing on our thinking. As regards the orderly functioning of the market, the incident seems to be behind us. It is worth noting, though, that even at

the height of the period of uncertainty and apprehension early last week, the nation's financial markets did continue to function reasonably well.

The incident will force many market participants to review and revise some market clearing and financing procedures and conventions that may have produced abuses. In my opinion, the review of market practices should be a job in the first instance for the private sector, motivated by its own healthy self-interest in sound business practices. At the same time, I believe that there is a useful role for the Federal Reserve -- as informal monitor of the Government securities market -- to be a concerned, aware, and articulate observer of the market's self-evaluation process. For example, we understand that plans are underway for the Association of Primary Dealers in Government Securities to take a close look at the market pricing conventions in lending securities that may have facilitated Drysdale-type operations, and we expect to join them in that review. That kind of cooperation would be entirely consistent with the informal surveillance role that the Federal Reserve and the Treasury have exercised over the primary Government securities dealers in recent years.

Inevitably, an incident of this kind raises a question about the adequacy of the present informal official surveillance of the Government securities market. Previous Treasury-Federal Reserve studies of this question have concluded that a more formal and broad regulatory structure would not be justified,

although that is not to say the question should not be reconsidered from time to time. It seems to me that a Drysdale situation, while serious, is not in itself sufficient reason to come down hastily on the side of broader and more formal regulation. Formalized regulation could well add to the costs and impede liquidity in this highly efficient market where the Treasury finances its debt and the Fed conducts monetary policy. Notwithstanding, it seems appropriate for the Federal Reserve to do a comprehensive review of this question, and we would, of course, invite cooperative comments from other agencies and market participants.

The important point to be made here, it seems to me, is that it is still too early to draw any firm conclusions about the need for further regulation. We are in the process of examining relevant bank procedures and controls. Certainly some market practices need careful review and may require modification. But more general conclusions will have to await a much clearer picture of the details of the Drysdale incident than we have been able to piece together during the past week. In the meantime, we can feel some satisfaction that the market behaved in a reasonably stable way, despite its concerns and uncertainties.

Mr. SOLOMON. It's hard to know what to summarize. I've given a fairly detailed chronology. I think I've gone right to the heart of what the issue is now, by telling you that in my view, it's a combination of these two practices: Blind brokering and the failure, when borrowing securities, to put up collateral or money, which is not only 100 percent of market value but also includes the value of the coupon, the accrued interest in the coupon.

I think that Chase would be the first to admit—now, having subjected themselves to the possibility of substantial losses—that there could have been improvement in their control procedures. But on the other hand, we have to recognize that that's not limited only to Chase. Manufacturers Hanover is also experiencing losses, but—evidently much smaller losses.

I would like to keep an open mind on the question of regulatory authority. Regulatory authority is no panacea. We have seen problems developing in markets where there is regulatory authority. On the other hand, I think we should keep an open mind on it, speaking for myself personally; and therefore, we will be actively reviewing the whole question of regulatory authority. But more immediately, we will be participating with the primary reporting dealers in reviewing the control procedures, in reviewing these two key points that I mentioned earlier.

I think that, just as in previous situations which have given rise to a tightening of procedures, the market has proceeded to function well and efficiently. I would assume there's a very good chance that these two areas, that I have specifically mentioned as being the cause of the Drysdale situation, will be constructively addressed.

Now, at the same time we will be looking at this question of regulatory authority. I'm not talking about across the board, because I don't think that seems to be indicated. We feel that our informal surveillance is quite tight and reasonable in regard to the 36 primary reporting dealers. But of course, there are hundreds or thousands of people trading in Government securities, in the secondary market and if something more is needed there, we would look at that. But that would be extremely cumbersome.

It may be, however, that there is a certain minimum threshold point, in terms of volume and transactions, and beyond that point we should get information.

COLLATERAL TO COVER ACCRUED INTEREST

Senator D'AMATO. Let me ask you this, Mr. Solomon. You touched on one important point, as did Mr. Stalnecker, that the collateral did not cover the accrued interest. In this case, it went into hundreds of millions of dollars.

Therefore, it would have taken hundreds of millions of dollars to cover it.

First of all, do you think, in light of the events which occurred, that there should be a requirement that the collateral does cover the accrued interest as well as the principal amount?

Mr. SOLOMON. I think this is the very first item on the agenda that's being looked at by the Government Dealers Association, and probably the PSA. I think that this is something like a previous

market situation. There was a case a few years ago—I believe it's called the Financial Corp.——

Senator D'AMATO. Isn't this something that the Federal Reserve has an interest in?

Mr. SOLOMON. We have a definite interest, but we have no rule-making authority. On the other hand, I don't know whether it's necessary to correct this particular situation. If we all come to the view—the dealers and ourselves—that this should be corrected, this will be the new standard of behavior in the market, then I don't think that it requires legislation for that to come about in an effective way.

Senator D'AMATO. Shouldn't it seem pretty obvious that this should be done?

Mr. SOLOMON. Even though I hesitate to say so, since we're still looking at it, my instinct is, and my preliminary view, Senator, is yes, I think it should be done. Because this is the way Drysdale accumulated working capital with which to speculate.

Senator D'AMATO. Then let's go to another point.

Had this been the practice, this situation couldn't have taken place, could it? Drysdale couldn't have leveraged itself into a position like this, could it?

Mr. SOLOMON. Not as easily, by any means. It would have been a horse of a very different color. I'm not saying that the problem——

Senator D'AMATO. They may have had losses, but not nearly of the same magnitude. Neither Chase nor the other investment houses would have been subjected to the incredible losses that arose as a result of—if you want to call it a loophole, the nonexistence of a rule or practice that required that the accrued interest also be collateralized.

Mr. SOLOMON. I think the entire Government investment community, securities investment community, is now very, very aware of this. I believe that there is a very good possibility that they will arrive at that conclusion.

The whole history of markets, and particularly the Government securities market, has been one where a situation may come along, an isolated instance, as Mr. Stalnecker indicated, and it reveals some deficiency in the collateralization, the margin, whatever it may be.

For example, as I said, before the Financial Corp. situation, RP's were not adequately margined. They are today, whereas reverse RP's are not, because of the failure to address this accrued interest factor.

So therefore, I have confidence in that, and as I say, regulation is such—there's no panacea, because we have seen situations in the regulated area where you get problems and failures. On the other hand, I have an open mind to it. I don't have an ideological view in regard to that issue at all, I assure you. We will look at this very objectively.

Senator D'AMATO. Now, we see one example where a rather modestly capitalized operation—I'm talking about Drysdale Government Securities, because it was spun off from the parent corporation; is that not correct?

Mr. SOLOMON. Right. It's apparently independent.

Senator D'AMATO. That's right.

We see a rather modestly capitalized operation act as a catalyst that results in hundreds of millions of dollars' worth of loss as a result of this—let's call it loophole, for lack of a better word; if you have a better word, fine.

It seems to me that Senator Riegle has raised an important question: What's out there? Are there other firms that may be involved in the same kind of situation?

And it seems to me that the regulatory agencies should review this matter as expeditiously as possible, so that the public can have confidence that there aren't other Drysdales percolating, and that within a period of months, we will find others cropping up.

Do you think that's reasonable?

Mr. SOLOMON. It is and it isn't. Let me put it this way:

We have very close contact with the 36 primary reporting dealers. We get extensive daily reporting, we get monthly reporting, we get yearly reporting. There are, outside of these primary dealers, what I would call "trading companies," "trading firms," let's say; but there are also foundations, even universities and individuals, who are trading Government securities in the secondary market.

If you try to reach out, to have them all report, you're talking about thousands and thousands and thousands of trades. I don't think that's feasible.

On the other hand, it may very well be, after review, that one can find a noncumbersome way that, beyond a certain threshold of transactions, that it might make sense. I'm just throwing this out as a possible hypothesis.

We have not done any real work yet in this area, as to how one would go about that kind of situation, where one would want to have a certain amount of reporting. And even then, of course, you can never be sure that you're going to capture a situation because, if a firm wishes to be very imprudent, very aggressive, and cut the margin closely, be very speculative, it may be that between reporting periods, a problem could develop.

So, one has to look at a very complicated market, and try to come to a fairly balanced and reasonable approach, as to what will be the value of imposing some kind of reporting requirement on this whole universe, or a part of this universe, outside of the reporting primary dealers, and see what benefits one will get in exchange.

And I assure you, Senator, we will look at that with an open mind.

Senator D'AMATO. Senator Brady.

Senator BRADY. Mr. Solomon, I'm wondering whether you have any idea at this time as to where the collateral that was supposed to be covering these transactions was placed?

Was it placed with the banks or with the trading institutions?

Is there any knowledge——

Mr. SOLOMON. My understanding is that with regard to Chase, Drysdale was doing mostly reverse RP business, which means borrowing securities and putting up cash primarily, it could be collateral; and it puts it up with Chase, is my understanding. Let me make sure on the technicality of this, that Mr. Sandberg agrees.

Mr. SANDBERG. That's correct.

Mr. SOLOMON. Yes. That's correct. It was done with Chase.

In the case of Manufacturers Hanover, they happened to be financing the bulk of Drysdale's long position, and they were also getting the collateral put up with them.

Senator BRADY. I don't want to belabor this matter, Mr. Chairman, but I wonder perhaps if it would be constructive if somebody tried to give us a little schematic of the transaction, as to how it actually had taken place. Would that be possible? Just to sort of trace the steps that——

Senator D'AMATO. We have three distinguished panelists. I would hope that one would like to go through the——

Mr. SOLOMON. I would imagine, without any question, Mr. Sandberg is the most technically knowledgeable.

Senator D'AMATO. Mr. Sandberg, just for the record, if you would give your name and your title.

Mr. SANDBERG. My name is Irwin Sandberg. I am a vice president of the Federal Reserve Bank of New York.

TYPES OF FINANCING TRANSACTIONS

There were basically two types of financing transactions that Drysdale was doing:

One involved the financing of its long position, which was largely done at Manufacturers Hanover. In that case, they would pledge their securities holdings in return for receiving cash. That cash was used to pay for the securities, which they had pledged with Manufacturers Hanover——

Senator BRADY. So, just to be clear, they would put up $10 million of Government bonds and get what kind of amount of cash?

Mr. SANDBERG. They would, in that case, overcollateralize a loan. That is, the lender of the money, the bank, would receive collateral that was in excess in value of the money they lent to Drysdale. There was no risk to the lender in that instance.

Senator BRADY. Could you give us just numbers?

Mr. SANDBERG. For instance, if there was a $100 million RP done, and Drysdale put up securities with a market value of $100 million, they might receive $96 million in cash. And there would be $4 million of capital of Drysdale used up in that example.

Now, on the other side of the transactions, Drysdale was doing what the market calls "reverse repurchase agreements," and the point of doing a reverse repurchase agreement is to be able to borrow securities.

In a reverse repurchase agreement, the parties are switched. Drysdale is now lending money to the bank, and the bank is lending Drysdale securities. Drysdale wanted those securities because it was selling securities into the market, and didn't own them, and needed to make delivery.

Senator BRADY. Could you give us the same kind of example that you gave us before, in terms of $100 million?

Mr. SANDBERG. Yes. Using those same numbers, Drysdale would be receiving securities with a value of, perhaps, $100 million, including accrued interest, and putting up cash, at perhaps $97 million or $98 million.

Now, that isn't any different than the bank had done in the RP transaction. The only difference is that the parties are reversed in where they stand in this transaction.

Mr. SOLOMON. And I think it's worth saying that if it had been early in the interest period, when there was very little accrued interest, you see, then Drysdale would not have been getting much more than it was putting up. It was only when there was a substantial amount of accrued interest, as one went farther into the interest period, that then this became a worthwhile way of developing working capital.

Senator BRADY. Then the equity in the reverse RP that you're talking about is the bank's equity?

Mr. SANDBERG. That is right. The convention in the market is that the lender of the money receives the margin of protection, and that was established because it was a sound and conservative rule. But that was established when the market only did repurchase agreements.

With the passage of time, the market participants realized that they could do repurchase agreements also as a form of borrowing securities. And, in fact, as one can see with hindsight, the margin should have been put up probably by the party that was initiating the borrowing, whether they were borrowing money or securities.

But the convention in the market continued to be that a party who borrowed the money was the one who would, in effect, put up the margin. It is a complicated subject. I am sorry if it is not always coming through clearly.

Those were basically the transactions that took place. So, in the case where the banks lent money to Drysdale and received securities, I don't think there was any money lost. It is not all clear yet. The records are still being looked at. But at least we are not aware of substantial losses to the banks in that sense.

The loss came on the reverse repurchase agreements, where the securities were lent to Drysdale and the banks received the money. Drysdale took the securities, sold them into the market, received funds in excess of the funds it gave to the banks to borrow those securities, and the excess was used as their working funds, with which presumably to leverage even larger positions.

And what seems to be the case is that in the running of those very large positions, risk positions, market rates moved in a direction that was adverse to Drysdale. So when May 17 came and they had to forward the interest due on those borrowed securities, they didn't have the funds because of losses sustained in market trades.

Senator BRADY. Let's unwind the position you have given us earlier with these two things. Then what happened to get us to the date that the event took place?

Mr. SANDBERG. When a party borrows securities through a reverse repurchase agreement or in any other form, the interest that is earned on those securities still belongs to the actual owner, to the lending party; and when the coupon falls due, as it did in this case, on May 15, which was a Saturday, May 17 was the payment date, the borrower of the securities has to forward the interest payment to the lender. And this is not an unusual transaction. And those interest payments——

Senator BRADY. What would the mechanics of that forwarding be?

Mr. SANDBERG. The forwarding would simply be that Drysdale would, if they had the security, collect the coupon and then pay those funds over to the Chase Bank, who would in turn pay their customers.

In this case Drysdale had apparently used those funds as working capital and had lost that capital in the process of taking risk positions. They had already sold the securities, of course, but they had received payment when they sold the securities, but they lost the money, apparently, in the course of their business operations, so they couldn't pass that along.

Senator BRADY. So, again, unwinding the transaction that you described earlier, what would normally happen would be to forward the interest back. I think you were talking about the Manufacturers Hanover. You were talking about the long position.

Mr. SANDBERG. In the long position Manufacturers Hanover had Drysdale securities. I should say—I have been generalizing here—both Chase and Manufacturers, I believe, did RP's and reverse RP's with Drysdale. They both did some of each transaction. I believe Chase probably did more of the reverse RP's relative to RP's and vice versa.

Senator BRADY. So on the day the interest was due, who should have been notified? Who was the first person that was supposed to be getting interest that didn't get it?

Mr. SANDBERG. The interest payments would be made to the Chase Bank. The Chase Bank, when it found it wasn't receiving its interest, knew there was a problem.

Now, as I understand what happened, Drysdale had in fact been in touch with the Chase Bank a day or two ahead of time to let them know that there might be a problem.

Mr. SOLOMON. I would like to volunteer a comment, Mr. Chairman and members of the committee, because I wouldn't want you to go away with a false impression. Even though I agree with Mr. Stalnecker that the market weathered this situation quite well—it was an isolated instance and the market weathered it fairly well—if it had not been resolved, then the uncertainty would have continued to build as we got closer to the next interest payment date, which would probably be May 31, I believe. And, therefore, it would not have stayed in the status quo situation.

As that date approached and there was nervousness in the market as to whether interest payments would be made, then you could have had the beginning of more of a ripple effect; you might say the beginnings of the seizing up of the market if that situation went on too long without being resolved.

So, therefore, I want to be sure the subcommittee understands that this is—this was, as Mr. Stalnecker says, an isolated instance——

Senator D'AMATO. Mr. Solomon, on that point, a question: Do we have reason to believe that there may still be some other Drysdale situations out there? I am putting it to you, let's not be a "tap dance" politician; I do that. [Laughter.]

I am not only asking it of you; I am asking it of your associate, of Treasury, and of Mr. Malawsky. Now, obviously in such a big

market there may be and there may have taken place other kinds of failures—but you understand what I am talking about—is there reason to believe that the potential exists for other Drysdale kinds of situations?

Mr. SOLOMON. Let me say this, Mr. Chairman, even though nobody can be, of course, 100 percent sure, right now everybody in the market, in the Government securities market, is so incredibly sensitive about the situation, reviewing its own books, reviewing whom it is doing business with. We have asked everybody to keep us informed.

Certainly, the 36 reporting primary dealers are looking at all of the firms they are doing business with. I am sure the banks are now reviewing the situation where they are acting as clearing agents, like Manufacturers Hanover and Chase.

So far nothing has come to light of any trading firm that has been unusually aggressive, taken very large, disproportionate positions relative to their capital. I would assume that there is every likelihood that if there is that type of situation it would have surfaced or will be surfacing and we will become aware of it very quickly. I think we probably would be aware of it already.

Now this doesn't mean that, once this type of situation is corrected through changes in practice in the market, that 5 or 10 or 15 years from now as innovation continues developing in the markets, that you couldn't get another what you call "loophole," Mr. Chairman—I don't know if that is the right word or not, but let's use that word for want of a better one—that you couldn't get another market practice developing where somebody could take advantage of it, who was willing to throw all prudence and caution to the wind.

But in today's situation, with everybody traumatized by what has happened and looking very carefully and reviewing their situation, I would say it was extremely unlikely that there is another Drysdale around.

Is that as clear——

Senator D'AMATO. Yes. I have a few more questions. Senator Brady has some questions. Senator Riegle is going to leave for the Commerce Committee. He has some questions.

I am going to ask Senator Brady if he wouldn't yield to Senator Riegle for purposes of one quick question.

Senator RIEGLE. I thank you for yielding. I actually have got a couple of questions here, but I think they are important to get on the record. I won't delay the committee.

We have a situation where we always have multiple committees meeting at the same time. I have that situation right now.

First of all, I would like to ask, Mr. Chairman, that we request of the SEC and of Mr. Malawsky, who is here today, that the SEC give us a full-scale report on what happened here, with any recommendations they think are appropriate, in terms of how we try to flag these situations in the future and prevent these kinds of things from happening.

And I would hope that we could make that request, Mr. Chairman, on behalf of the committee and see what their views as an independent observer are and see what they might recommend to us.

Senator D'AMATO. I would be interested in their overall assessment; however, I think we should really look to both the Treasury and the Federal Reserve—particularly, the Federal Reserve—to give us a detailed report on this. It should include a discussion of the regulation of the 36 primary dealers of the blind brokerage arrangements that are utilized in this market, and again, whether or not there are potential Drysdales ticking out there. I think that is a question that we want to get to the bottom of. And since it may take some detailed investigation and people are sensitive to the issues, this is the time to do it.

So, I will ask the staff to draft a request and submit it to all the members, if you are in agreement.

Senator RIEGLE. That would then include the SEC too? We would be soliciting their assessment?

Senator D'AMATO. We will certainly solicit their assessment. But, again, I think the primary responsibility will lie with the Federal Reserve Board and the Treasury Department.

[The following letter was mailed to the Federal Reserve Board:]

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C., July 2, 1982.

Hon. PAUL A. VOLCKER,
Chairman of the Board of Governors, Federal Reserve System, Federal Reserve Building, Washington, D.C.

Dear CHAIRMAN VOLCKER: This is to confirm the oral request made by members of the Subcommittee on Securities, at the hearing held on May 25, 1982, for a detailed report by the Federal Reserve Board on the circumstances surrounding the default of Drysdale Government Securities on May 17, 1982.

It would be most useful to the Subcommittee's deliberations if your report includes: (1) An explanation of the facts leading up to the default, and the events which followed it; (2) a description of the regulatory and supervisory tools which were available to deal with these events, including the precise nature and limits of direct regulation of all government securities dealers; (3) your analysis of the causes of the Drysdale situation, the potential dangers it posed, and the possibility of future disturbances in the government securities market, including the means by which market practices such as "blind brokering" are developed, policed, and altered (including the role of federal regulators in this process), and the powers which the federal regulators possess to detect, contain and correct market disturbances of any kind; and (4) a summary of any proposals you may be considering to strengthen your supervisory role over government securities dealers, and any recommendations you may have for legislative action.

We would appreciate your submitting this report to the Subcommittee by September 15, 1982. At that time, we will request that the Department of the Treasury and the Securities and Exchange Commission provide us with their comments on your report.

Thank you for your prompt attention to this matter.

Sincerely,

ALFONSE D'AMATO,
Chairman, Subcommittee on Securities.

PRIMARY DEALER REPORTING

Senator RIEGLE. Let me ask this, Mr. Solomon. You have 30, or over 30, primary dealers of which Chase is one and which you exclusively work with in terms of moving Government securities through them out into the market, and it would appear that being a primary dealer would give a bank or an institution certain credibility in the marketplace because they are preferred; they have the standing and special status because of your designation.

Don't you think the Fed ought to have rulemaking authority to provide standards for safe and sound practices for the primary dealers?

Mr. SOLOMON. Probably that is the least of our problem, for this reason——

Senator RIEGLE. Before you scale that down, shouldn't that be done?

Mr. SOLOMON. We find that they will cooperate with us fully for this reason: we will only deal with them if they report to us daily on their positions. They have to report, both in their outright holdings, in their futures, their cash, et cetera, et cetera.

Second, they have to give us a monthly profitability statement and, third, a detailed annual financial statement.

We have meetings with them regularly. They are responsible. We are careful before we accept somebody as a primary reporting dealer. He has to have at least 1 percent of the total volume of customer trading.

Drysdale had applied to us, and we had not given them that status.

Senator RIEGLE. Could you give us that information for the record—I think it would be useful. I was not aware of that. I think it would be important if we got whatever is in your record on the Drysdale application, which you chose not to approve.

Mr. SOLOMON. Right. They had approached us to see whether they could become a primary reporting dealer.

Senator RIEGLE. When was that?

Mr. SOLOMON. I think it was back in February, or was it March?

Senator RIEGLE. In fact, it was in April.

Mr. SOLOMON. You turned them down?

Senator RIEGLE. They talked to us about applying.

Mr. SOLOMON. They talked to us about applying, and we said they were, of course, premature. They were not a well-known firm. We would have to observe their behavior, and we would have to see. We told them what the general parameters and the criteria were, and we of course would not consider it at that point.

And we told them they would have to start filing information with us. They never began that filing. So that——

Senator RIEGLE. Were the other primary dealers aware of that? Would Chase have known about that?

Mr. SOLOMON. Yes, even though we don't make any announcements in practice. It gets fairly technical here, but in practice they would want access to certain wires, direct access to certain wires so the other reporting primary dealers would know about it, that Drysdale or a company, firm *X* was interested in becoming at some point a primary reporting dealer.

Senator RIEGLE. I would like to ask, if we may, to get whatever you have in your records as they exist at that time when that request was made and why you turned it down. I think it would be useful for us to know what took place at that time.

Mr. SOLOMON. We can give you a summary, although I want to emphasize again it was a verbal approach to us. It was the standard procedure, the initial contact.

Senator RIEGLE. But somebody must have filed memorandums.

Mr. SOLOMON. We can give you a summary, yes, of those contacts.

[Mr. Solomon subsequently submitted the following information for inclusion in the record:]

SUMMARY OF MEETING WITH OFFICERS OF DRYSDALE GOVERNMENT SECURITIES, INC., ON APRIL 23, 1982

On April 23, 1982 Richard Taaffe, President, and Bill Hogan, Trading Manager, Drysdale Government Securities, Inc. ("Drysdale GSI"), met with Peter D. Sterrlight, Senior Vice President, Irwin D. Sandberg, Vice President, and Edward J. Ozog, Manager, Open Market Operations Function of the Federal Reserve Bank of New York, to discuss the desire of Drysdale GSI to establish a reporting relationship with the Bank.

Drysdale GSI is an affiliate of Drysdale Securities, a firm founded in 1889. A few years ago a number of wealthy individuals purchased Drysdale. A David Hueweter was also reportedly instrumental during the takeover.

Drysdale opened the GSI in February 1982. Drysdale GSI is not a subsidiary of Drysdale Securities. Drysdale Securities owns $5 million of preferred shares in Drysdale GSI and holds two seats on its Board. The balance of Drysdale GSI's capital is composed of $8.2 million of common stock and $10.3 million of subordinated debt. Drysdale Securities has only $8 million of capital, only about a third of the amount of its new affiliate's capital.

Drysdale GSI employs about 20 people, including 5 traders, and is located at 65 Liberty Street, the old Chamber of Commerce building, which it now owns. It has requested membership in the Primary Dealer's Association and brokers' wires.

As usual in such preliminary meetings, the Drysdale GSI representatives were informed of the requirements for becoming a primary reporting dealer and of the need for us to review periodic reports from them on their volume and positions, before we would be able to consider their request to become a primary reporting dealer. Drysdale GSI indicated its intention to soon begin reporting volume and position data to the Federal Reserve on a periodic informal basis.

Senator RIEGLE. I have two other items. I don't want to trespass on the time of others. First, was Chase in these transactions the primary dealer?

Mr. SOLOMON. No. In these controversial transactions Chase was acting as what we call the clearer. There are also in this market what are called finders. A firm called Buttonwood was acting as a finder bringing Drysdale together with Chase and security holders on the other side with whom Chase dealt, to complete the transaction. The finder shares in the fee. The finder itself does not have the financial standing or the access to Fed wire to act as a clearer.

POLICY POSITION OF THE FED

Senator RIEGLE. I would like to pursue that. I won't right now. Let me ask you a different question. It is said in several stories, I just cite one story here, that the Fed at the time this thing was breaking had given the signal that they would provide funds to assist commercial banks in meeting unusual credit demands related to market problems. Was there a signal given by the Fed, by you or anybody else in the Fed, that you would somehow change the availability of credit at that point to absorb any shock that was coming off this thing? Was that a policy position that the Fed in fact took on?

Mr. SOLOMON. Those are two separate points, and they're not that complicated; they're worth distinguishing. One is, we said that our discount window would be open in the normal way—but making a point of saying it, which is reassuring to the market—would be open in the normal way to the commercial banks that had access to that window, if there was a liquidity need, because of this Drysdale situation. That was one thing. We did not change our standards. They always have to put up full collateral.

The other thing where we said we would be more flexible, is that we will lend securities, not money, but will lend Government securities to primary reporting dealers when there is the possibility of

what is called "a fail," a failure of delivery. We require full collateral when we do that, and there we said that we would be somewhat more flexible in our terms, because we were afraid there might be some disturbances, and there were beginning to be some signs that there were, in the Government securities market, and we didn't want to begin to see a chain reaction. So we said that we stood ready to be somewhat more flexible and, in practice, the volume of securities that we lent out, always fully collateralized, increased. We had been averaging about $200 million daily outstanding average. That increased over the next couple of days up to $600 million, and then increased thereafter to even higher levels.

Now we did that to make sure that the Government securities market continued to function in an orderly way, and that is—therefore, I'm distinguishing between the two. It has no impact, incidentally, on money supply—even though you're not discussing monetary policy—it does not have an impact on what we call a nonborrowed reserve path.

Senator RIEGLE. There are differences in opinion on that. Is that a written——

Mr. SOLOMON. We know definitively whether it does or it doesn't. I'm talking about directly. Now you can have psychological reactions, of course, but I can assure you that since we are the ones who do what we do, we know that it does not affect the nonborrow——

Senator RIEGLE. Is that a written policy? That policy that you just described, the action that you took, is that an established written policy procedure for an emergency situation that kicks in at a time like that, or is it an ad hoc kind of response where you just feel your way through in emergency?

Mr. SOLOMON. It's an obvious response. There's no written procedure. There's no standard written procedure to deal with a Drysdale type of contingency.

Senator RIEGLE. You see how this all connects, because if you fail, if the Fed fails to do a sufficient job of monitoring the action of these primary dealers, somehow down the line, regardless of where the responsibility finally is placed, the Drysdale-type operations get into trouble and they fail, and you get a chain reaction, and reduction in public confidence, and so forth. You, in a sense, can respond to that breakdown in the mechanism and perhaps the way you monitor these things, by adjusting your own internal practices and make money available. And so, in a sense, you can, if not correct your own mistake, at least handle it for a period of time.

I must tell you, I'm uneasy about the fact that apparently things are done verbally. There are not written procedures. Even now, after the fact, we don't know precisely what happened. We have not yet been able to clearly establish today, and I doubt that we will, precisely what took place in this case.

Mr. SOLOMON. I'm sure we will, Senator.

Senator RIEGLE. I know we will at some point down the road, but I'm saying, it seems to me you ought to have a better ability to control things of this size and importance and consequence, before they happen, and if you miss the boat there, certainly, an ability to catch up with the facts faster than you have been able to do so far.

Mr. SOLOMON. I thought we caught up with it pretty darn fast, and we had everybody in there in a series of meetings looking for

solutions. Now there is no way of putting down a rule which is going to apply to all possible forms in which a contingency might arise. We are there—we are lenders of last resort. We are not there to bail out a particular firm, but we're there to prevent a chain reaction which would seize up the markets.

Senator D'AMATO. Would it be fair to say, Mr. Solomon, that your role is to add some stability to what might be a tumultuous situation, for example, by letting it be known that there is access to the discount window?

Mr. SOLOMON. That's exactly what we did, sir.

Senator D'AMATO. I would like to ask Mr. Malawsky, the Regional Administrator from the New York Regional Office of the SEC, who has been conducting an investigation of these events, if he wouldn't give his statement at this point. I think we should include his remarks in this panel, because I think there are certain things that we would all like to ask him as well as the other witnesses.

Mr. Malawsky.

STATEMENT OF DONALD MALAWSKY, REGIONAL ADMINISTRATOR, NEW YORK REGIONAL OFFICE, SECURITIES AND EXCHANGE COMMISSION

Mr. MALAWSKY. Thank you, Senator.

Mr. Chairman, members of the committee, I have been asked to describe the role of the Commission in the Drysdale matter.

IMPACT ON BROKER-DEALERS

This situation came to our attention last Tuesday morning, May 18, when Paul Volcker notified SEC Chairman John Shad, of the problem created by the failure to pay some 30 dealers accrued interest on various government securities loaned by them to the Chase Manhattan Bank and reloaned to the firm of Drysdale Government Securities. It was not entirely clear at that time why the payment had not been made or the amounts involved. An immediate inquiry was undertaken to ascertain the circumstances of the failure and the impact on broker-dealers.

That morning the Dow Jones broad tape carried reports to the effect that significant claims were made against Chase as a result of a failure by Drysdale Government Securities to pay certain large banks, registered broker-dealers, and others, including unregistered broker-dealers, $160 million in accrued interest payments on borrowed securities as of the prior day, Monday, May 17. It also appeared that several billions of dollars of various U.S. Government securities were the subject of repurchase and reverse repurchase transactions involving Drysdale Government Securities. At that point, our concern focused on whether any registered broker-dealers with public customers might be in jeopardy because of the failure to pay the accrued interest.

We were advised by the New York Stock Exchange that inquiries it made of its member firms indicated that no member firm was in jeopardy as a direct result of the failure to pay the accrued interest. The NASD was also contacted, and it reported that none of its members was in jeopardy.

By midday SEC examiners had been sent to Drysdale Government Securities to gain access to its books and records. We could

not, however, gain access to the books and records of the firm on a voluntary basis.

The next morning, May 19, Manufacturers Hanover announced that it had agreed to pay $29 million in accrued interest, and Chase announced that it had agreed to pay accrued interest of $160 million. Chase agreed that it would assume Drysdale's obligations, except those assumed by Manufacturers Hanover, and stated that it was taking an assignment of Drysdale Government Securities' positions and certain other assets. The agreement of both banks to pay the accrued interest alleviated some of the potential concern regarding the adverse impact of the default.

Drysdale Government Securities is not registered with the Commission as a broker-dealer. That is simply because the firm is exempt from such registration, since it deals exclusively in government securities. Accordingly, we do not have the statutory power to examine the books and records of Drysdale Government Securities, although we do have authority under the Federal securities laws to investigate possible violations of the antifraud provisions. Nevertheless, the Exchange Act and the rules adopted thereunder do not subject Drysdale Government Securities to financial responsibility requirements or require it to make and keep books and records of the type registered broker-dealers make and keep, including those concerning securities positions. To date, we have been unable to secure a financial statement or ascertain complete securities positions for Drysdale Government Securities.

On Wednesday, May 19, the Commission issued a formal order of investigation, and, immediately thereafter, we served a subpena on Drysdale Government Securities for all pertinent books and records. Since then, other subpenas have been issued for the production of books and records, in order to obtain additional data on the trading activities of Drysdale Government Securities.

The thrust of our investigation is to determine whether securities acts violations occurred and the practices that may have adversely impacted on registered broker-dealers. While more cannot be disclosed about the Commission's investigation at this time, we want to assure the Committee that an expeditious and thorough investigation will be conducted.

I appreciate the opportunity to appear before you today.

I will be happy to answer any questions the committee may have.

Senator D'AMATO. Senator Brady was following a particular avenue of questions that he would like to continue. Senator Brady.

MARKET REACTION

Senator BRADY. I would like to get back to Mr. Solomon and Mr. Sandberg, and ask them the same question that I asked Mr. Stalnecker earlier with regard to market action in this period; whether, in your opinion, that the fluctuations that occurred in the market during this week were abnormal. I have been away from Wall Street for about 4 or 5 weeks, but it does seem to me that the market behaved in a way that wasn't any different than it behaves while it waits for your weekly figures to come out. But I don't want to make that assertion myself. I'd be interested in your opinion.

Mr. SOLOMON. I think I basically agree with that. Given the kind

of volatility in interest rates that we've seen in the last couple of years, this was not that unusual. The market behaved, I think, in a fairly normal way, although there are obviously some repercussions. Do you want me to go through, or Mr. Sandberg better repeat the Monday afternoon reaction, whether the Tuesday morning——

Senator BRADY. I was just interested in your opinion.

Mr. SOLOMON. My general opinion is that the markets behaved in a reasonably stable way.

Senator BRADY. I'm not belittling the enormity of the loss that may be and may continue to be. While that loss may look large in absolute terms, with regard to a rather large market, it didn't take great alarm at the transaction that was taking place. Is that a fair conclusion or not?

Mr. SOLOMON. I think one point worth making is that the losses may not turn out to be quite as large as the figures that had been put out. Manufacturers Hanover particularly, and even Chase, may find as they liquidate these Drysdale securities that they have taken over, and particularly where they were adequately margined, that there may be some reduction of losses.

Senator BRADY. Another question: has the public lost any money in this transaction? If you X out Drysdale itself, who is it that has lost the money we've talked about. In terms of protecting the public. Has the public lost money or hasn't it lost money?

Mr. SOLOMON. The individual investor, in the sense that we normally mean the public, has probably not lost any money. There may be litigation in regard to the question of whether Chase was acting as an agent or it should be considered a principal; and depending on the outcome of that litigation, one can see if it went a certain way that Chase might not be or Manufacturers Hanover might not be the only loser. There might possibly be some of the firms or other institutions whose securities were actually lent through Chase to Drysdale, but I think in the sense in which you mean the public, I do not see any losses.

Now, we don't know, of course, whether Drysdale is solvent. It's certainly not solvent in the sense that it can continue doing business because nobody will deal with them. Whether it is insolvent in the sense that there may be some—aside from the losses that we have heard about, whether there could be some modest size ordinary trade debts, credits that they owe, and people may get burnt on that, we don't know.

Senator BRADY. But with regard to the $160 million, is it fair to assume that this money will be absorbed by the shareholders of Drysdale and the shareholders of the banks or the investment banks. Is that a fair conclusion?

Mr. SOLOMON. Right, depending on whether or not there is litigation and the outcome of it. I prefer to use the Chase figure of $135 million after-tax loss, because I don't know exactly what their tax bracket is and how they calculate, but that's their best estimate of the upper limit. It may very well be less than that.

Senator BRADY. We've read about, in the reports of the transaction, that it may be another hit point coming up at the end of May. Do you have any information on that, or is this figure of $135 million what we're going to see? Is there another interest?

Mr. SOLOMON. There is another interest payment coming up on

May 31. I am quite confident now that there will not be a problem, in view of the precedent that was set in resolving the May 17 problem.

Senator BRADY. Do you have any ballpark figure on that?

Mr. SOLOMON. I would assume there is a very good chance that the securities will be liquidated before that date. I can't be 100 percent sure, but I would assume that there is a very good chance and that, therefore, that situation will not arise.

Senator BRADY. Thank you.

Mr. Malawsky, I notice in your prepared remarks you make the assertion that the stock exchange made an inquiry as to whether the events which unfolded from the Drysdale matter were impairing any of the firms involved; and it's your conclusion that the firms with which the bank and Drysdale were dealing were able to absorb the individual capital amounts that were attributable to each of them, without any impairment of their method and way of doing business; is that correct?

Mr. MALAWSKY. That's correct, Senator. I might point out that many of the dealers are not registered with the Commission. Some of them are subsidiaries of brokerage firms that are registered, but these subsidiaries are not required to be registered with the Commission since they deal solely and exclusively in these securities; so that when the inquiry was made from the various firms, the response that came back was no, there was no jeopardy with respect to any of those firms. So we were satisfied at that point, at least with respect to the survey done by the Exchange and the NASD.

Senator BRADY. So the reports we read in the newspaper that the firms that were doing business in this transaction were in jeopardy because of the transaction, that was just an initial report and not something that was substantiated in your investigations later on? It seemed to me that the amounts, that although they're big, $5 and $10 million pieces of capital, they're small in regards to the total amount of capital that the Wall Street firms have at their disposal; is that your conclusion?

Mr. MALAWSKY. Right. It certainly appeared that way. The only concern last week was with respect to Drysdale Securities which was the member firm, a registered broker dealer and obviously a name, a common name, and that was dealt with by the New York Stock Exchange, it's problems, and we felt that that problem was dealt with adequately by the exchange and resolved and the firm remaining strong.

Senator BRADY. Thank you, Mr. Chairman.

Senator D'AMATO. Mr. Malawsky, let me ask you what amount of capital would Drysdale Government Securities have been required to have if the SEC's net capital rules has applied to it?

Mr. MALAWSKY. I don't know the answer to that question, simply because we have not had access to its books and records. The net capital formulas and other financial responsibility requirements under the Exchange Act would have to be applied based on an examination of those books and records and all the positions that the firm maintained. Obviously, we don't have that information at this point so I can't give you an answer.

Senator D'AMATO. Does it disturb you at all that a firm with such relatively small capitalization could have been trading on a volume equivalent to a major dealer?

Mr. MALAWSKY. I'm not sure I can answer that question. Perhaps it's best directed to the Fed or to the Treasury. Obviously the impact of Drydale's failure, which was a result of its trading activity, sent shockwaves through the markets, but I really don't have enough information at this point to answer your question.

Senator D'AMATO. How do you think the situation would have been different if it had been an investment banking firm with public customers, instead of a bank, which had acted as an intermediary between Drysdale and other dealers?

REGISTRATION WITH SEC

Mr. MALAWSKY. Now we're dealing with the application of the Securities Exchange Act. First of all, the brokerage firm would have to be registered with the Commission. It would be subject to periodic examination by our examiners and would have to maintain a certain amount of capital to remain in business in conformity with the financial responsibility requirements. It would be required to make and maintain certain books and records in a fashion which would quickly disclose to us all of their transactions, who they were doing business with and what their exposure was with respect to their transactions.

Senator D'AMATO. Do you think that such requirements would be unduly burdensome for government securities?

Mr. MALAWSKY. Again, I don't know if it would be unduly burdensome. I know that there are thousands of brokers who are registered with the Commission who act as government securities dealers, they are required to comply with Commission rules and they do it reasonably well.

Senator D'AMATO. Mr. Solomon, Drysdale Government is not registered as a broker-dealer. Should it have been?

Mr. SOLOMON. No, sir, it should not have been a primary reporting dealer. It didn't even meet the qualifications.

Senator D'AMATO. I'm not saying primary dealer. It's not registered as a broker-dealer. If it had been so registered, could this situation have been prevented?

Mr. SOLOMON. You mean if it had been registered with the SEC because the law was changed so that firms dealing only with government securities should have been registered as broker-dealers, would this situation have been prevented? I doubt it very much.

Senator D'AMATO. What do you say to that, Mr. Malawsky?

Mr. MALAWSKY. Senator, we have seen over the years firms that have failed because of trading practices and other practices. There is no guarantee that a firm will not fail simply because we are regulating them and the rules apply. There is a business aspect involved here and there are risks that even the regulated firms take, and sometimes result in problems for those firms. I don't know whether in this case the rules and regulations of the Commission, if they were applicable, would have prevented this problem or not. I can't go beyond that.

Senator D'AMATO. Senator Brady, do you have any other questions?

Senator BRADY. No.

Senator D'AMATO. The staff will be communicating on behalf of the subcommittee with the Federal agencies represented here today, to request some more detailed information from them I

think it's very important to follow up when we find the kind of—let me characterize it as—adventuresome trading that has taken place by one relatively small company, that has resulted in the kind of problems that were created.

Notwithstanding the fact that the Federal Reserve acted in this case to minimize the fallout, and the fact that the two major banks involved also stepped up to minimize the market disturbances that otherwise could have occurred, we have an obligation to see to it that we minimize the likelihood of these kinds of things taking place in the future and that we assure the proper confidence in the marketplace that is absolutely necessary. So we will be following up on this hearing, and we will have additional hearings into this matter as your investigation into these matters progresses, and you are in a better position, Mr. Solomon, to report to us.

I want to thank you for your response to our inquiry, recognizing that all of the facts are not in, that all of you are in the process of gathering this information. We look forward to receiving your continued cooperation. Again, I think this is the kind of matter that deserves our quiet but persistent attention.

This subcommittee stands adjourned.

[Whereupon, at 11:30 a.m., the committee was adjourned.]

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